

# SELF-EMPLOYMENT

## AND ECONOMIC MOBILITY

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### KEY FINDINGS:

- Empirical evidence on the role of self-employment in intragenerational economic mobility is mixed and differs by subpopulation.
- Self-employed men on average have lower initial earnings and earnings growth than their wage/salary counterparts (Hamilton 2000).
- Self-employment leads to an increase in the earnings distribution for low-income individuals but a decrease for high-income individuals (Holtz-Eakin, Rosen, and Weathers 2000).
- Self-employed less-educated young men and women experience faster earnings growth on average than their wage/salary counterparts after a few initial years of slower growth (Fairlie 2004a).
- Black-owned businesses lag substantially behind white-owned businesses in sales, profits, employment size, and survival probabilities (Fairlie and Robb 2003). However young self-employed black and Hispanic men have greater earnings over time than their minority wage/salary counterparts after slower initial growth (Fairlie 2004b).

*Self-employment has held out the promise of economic mobility to generations of Americans. The success of the self-employed pulling themselves up by their own bootstraps is mythologized to the point of becoming one of the defining characteristics of the American experience and history. Like many myths, it may be based on exceptional cases rather than common experiences. Understanding the contemporary experiences, outcomes, and impact of self-employment on mobility is necessary to properly evaluate the contribution and potential of self-employment for increasing mobility in the U.S. population. In this review, we describe the mechanisms by which, and examine the evidence for the effect of self-employment as a particular institutional form of work that may have mobility outcomes different from standard employment. This first section provides an overview of the mechanisms and empirical findings, with a link to a more detailed review. Based on the literature review, this section also provides some suggestions for further research.*

Self-employment can contribute to or constrain economic mobility through several mechanisms. Self-employment can affect both **intragenerational** and **intergenerational** economic mobility through its direct effects on income and wealth.<sup>1</sup> Self-employment can also have indirect effects on economic mobility (both intra- and intergenerationally) through mediating outcomes such as human capital and social capital which in turn can affect levels of income and wealth. These direct and indirect effects of self-employment may differ importantly by subpopulation (race/ethnicity, gender, immigrant status) as some groups face discrimination or other mobility limits in standard employment. The effects can also differ by types of self-employment as some workers intend to establish “high growth” businesses while others make explicit economic and non-pecuniary tradeoffs in establishing “lifestyle” businesses. These mechanisms are further described below along with a review of empirical evidence relating to them.

Based on the limited empirical literature, we find that empirical evidence on the role of self-employment in intragenerational economic mobility is mixed and differs by subpopulation.

- Self-employed men on average have lower initial earnings and earnings growth than their wage/salary counterparts (Hamilton 2000).
- Self-employment leads to an increase in the earnings distribution for low-income individuals but a decrease for high-income individuals (Holtz-Eakin, Rosen, and Weathers 2000).
- Self-employed less-educated young men and women experience faster earnings growth on average than their wage/salary counterparts after a few initial years of slower growth (Fairlie 2004a).
- Self-employed young men from disadvantaged families earn more than their wage/salary counterparts but self-employed young women from disadvantaged families earn less (Fairlie 2005a).
- Black-owned businesses lag substantially behind white-owned businesses in sales, profits, employment size, and survival probabilities (Fairlie and Robb 2003). However young self-employed black and Hispanic men have greater earnings over time than their minority wage/salary counterparts after slower initial growth (Fairlie 2004b).
- Historically immigrants were self-employed at greater rates than natives. However, there has been a decline in recent decades and by 1997 natives had higher self-employment rates than immigrants (Camarota 2000).

All of the studies cited above attempt to control for selection into self-employment. That said, it is difficult to measure the causal relationship between self-employment and economic mobility because individuals who choose self-employment likely differ from those who choose wage or salary employment in unobserved ways. This is an ongoing methodological issue to keep in mind while reading this review and in any future work on self-employment and economic mobility.

Research on self-employment typically examines the income produced by self-employment over a relatively short period or intragenerationally. We did not find any studies that examined the impact of self-employment on the economic status of a subsequent generation. There also appears to be limited research examining the impact of self-employment on **wealth mobility**. This may be a significant shortcoming for the self-employed who forgo current income for the expectation of future wealth from growth of business assets.

Limitations in current data and research raise several questions that could be addressed by further research. First, over what time period should the effect of self-employment on mobility be measured? Is

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<sup>1</sup> This review focuses on income and wealth as direct measures of economic mobility, though multidimensional measures such as socioeconomic status (SES) are important in sociology, education, health, and other literatures. There is a large literature in studies of intergenerational mobility using SES measures. See for example Treiman and Ganzeboom (2000).

5, 10, or 20 years the critical threshold to evaluate business survival and performance? The answer and length of longitudinal data panels available to measure the impact has important implications for our ability to evaluate the role of self-employment in economic mobility.

Second, how does the relationship between self-employment and economic mobility change over the life cycle? Due in part to data limitations, much of the current limited literature focuses on the role of self-employment for young workers. But one might expect different outcomes for middle and older workers as the returns to self-employment and wage labor change. Studies of firm starts find those in their late 30s and early 40s are more successful than younger cohorts, and firm startup rates are very low for those in their late teens and early 20s (Reynolds 2004).

Third, how analytically useful is an undifferentiated category of “self-employment” when it encompasses self-selected groups with highly divergent mobility goals? Large segments of the self-employed may choose non-pecuniary returns in exchange for lower economic returns. “Self-employment” thus includes a potentially large group who explicitly choose employment with low mobility outcomes thus, in effect, constituting a sample selected on the dependent variable.

Fourth, how should the returns to self-employment be evaluated when supplementing other household income sources, such as a part-time job held by a spouse in a two-income family or self-employment that is a second job? Self-employment may generate low levels of income but provide enough of a marginal increase in family income or provide a marginal addition to income from a standard employment job to provide economic mobility. For example, one survey found most people starting a new firm had more than one income earner in the family (mean of 1.7; Brush and Manolova 2004).

## THE ROLE OF SELF-EMPLOYMENT IN CONTRIBUTING OR CONSTRAINING ECONOMIC MOBILITY

Self-employment can contribute to or constrain economic mobility through its direct effects on income and wealth and through its indirect effects by its impact on human capital and social capital.

*Intragenerational mobility* refers to changes in the self-employed person's own economic position (i.e., within their lifetime) whereas *intergenerational mobility* refers to changes in the economic position from one generation to the next. Intergenerational mobility can reflect both (1) how the next generation can use self-employment to change their economic position from that of their parent's economic position (independent of whether the parent was self-employed) and (2) how a parent's self-employment can affect the child's economic status. The table below illustrates these dimensions of mobility and self-employment. The effect of self-employment can also vary by subpopulation and business type. In this section we describe these dimensions and summarize the empirical evidence relating to them.

### Self-Employment's Effect on Economic Mobility

Dimensions of Mobility		Intra-generational	Inter-generational
Direct	Income		
	Wealth		
Indirect	Human Capital		
	Social Capital		

### Self-Employment and Income Mobility

Our review suggests that the empirical evidence on the role of self-employment in intragenerational economic mobility is mixed. For example, Hamilton (2000) using the 1984 Survey of Income and Program Participation (SIPP) shows that self-employed men (age 18-65) have on average lower initial earnings and lower earnings growth than their wage/salary counterparts. Hamilton does find that a handful of entrepreneurs earn substantial returns in self-employment relative to what comparable workers earn in paid employment. This seminal paper has led some to conclude that entrepreneurship does not seem to pay, on average, when looking at the strictly economic returns (Litan 2005). However, the findings in the literature are mixed, especially when analyzed by subgroup.

Holtz-Eakin, Rosen, and Weathers (2000) use longitudinal Panel Study of Income Dynamics data from 1968 to 1990 to examine one-year and five-year earnings mobility. They find that self-employment leads

to an increase in position in the earnings distribution for low-income individuals but a decrease in position for high-income individuals.

Fairlie (2004a) uses the National Longitudinal Survey of Youth (NLSY) from 1979 to 1996 to make comparisons among young less-educated workers. He finds that the self-employed experience faster earnings growth on average than wage/salary workers after a few initial years of slower growth. Simulations based on estimates suggest that earnings among young less-educated workers grow by \$771 more per year for self-employed men and \$1,157 more per year for self-employed women, than for their respective wage/salary counterparts (Fairlie 2003).

In a later paper, Fairlie (2005a) uses the NLSY from 1979 to 1998 to make comparisons among young workers from disadvantaged families (defined as both parents of the worker have less than a high school education). He finds some evidence that young self-employed men from disadvantaged families earn more than wage/salary workers, but that young self-employed women from disadvantaged families earn less than wage/salary workers.

We did not find any studies that examined the impact of self-employment on intergenerational income mobility.

### **Self-Employment and Wealth Mobility**

*Wealth mobility* reflects the increase in assets directly resulting from self-employment, such as assets of the business that directly accrue to the owner, or other direct benefits that increase the owner's personal assets. Wealth is an important factor in inequality and mobility. **And self-employment may be an important means of achieving wealth for some segments of the population.** Wealth is perhaps a more important factor in intergenerational mobility than income, and is weakly correlated with income—with correlations between income and net worth below 0.30 (see Kim, Aldrich and Keister (2004), for review, citing Keister (2000)). Despite the potential importance of self-employment in wealth mobility, we did not find any studies that have examined the returns to wealth from self-employment and currently available data may limit the extent of such research.<sup>2</sup>

While no known studies examine the effect of self-employment on wealth, a literature does examine the relationship between wealth and business start up. For example, Dunn and Holtz-Eakin (2000) use the National Longitudinal Surveys of Labor Market Experience (NLS) for 1966 through 1982 to examine intergenerational links in the transition to self-employment. They find that parental wealth (to a lesser extent) and human capital (to a greater extent) are more important determinants of self-employment than the self-employed person's own wealth. These findings suggest strong roles for family-specific human capital and the transmission of these skills within families. Grawe's review of the literature on wealth and economic mobility describes the role of **family wealth in self-employment**. However, other researchers argue that many entrepreneurs start their firms with little or no capital (Aldrich 1999). Kim, Aldrich, and Keister (2004) note that the Census Bureau's small business survey found the majority of business owners started their firms with less than \$5,000, and that other studies show personal wealth is not an important factor both because of the small capital requirements for many types of business and because they can use any number of "boot-strapping" methods to decrease capital needs.

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<sup>2</sup> Hamilton (2000) used an equity adjusted draw as one of his alternative measures of self-employment earnings. The equity adjusted draw includes the returns to the entrepreneur in the form of the capital gain (or loss) in the value of the business.

### **Self-Employment and Indirect Outcomes: Social Capital and Human Capital**

In addition to the direct monetary returns to self-employment in the form of income or wealth, self-employment can result in mediating outcomes that could contribute to or constrain economic mobility. As an *outcome* of self-employment rather than a determinant of self-employment performance, there has been little research on the development of *human capital* (both intra and intergenerationally) and on the development of *social capital*, such as extending or deepening social networks that provide access to those opportunities or resources typically not available in standard employment.

Social capital, defined as relations among persons that serve as a resource for action (Coleman 1988), may contribute indirectly to mobility outcomes in a number of ways. Coleman (1988) finds social capital important in the creation of human capital (which, in turn, is important in economic outcomes). Business formation and success may be affected by the social capital of its founders, such as the extent and diversity of social networks (e.g., Aldrich and Carter (2004)) and start-up teams (Aldrich, Carter, Ruef 2004). At the same time, entrepreneurs “construct new [social networks] in the process of obtaining knowledge and resources for their organizations” (Aldrich and Carter 2004). Changes in social capital could be one outcome of self-employment that affects mobility. The research on self-employment generally has not examined social capital developed as a result of self-employment and how it could affect economic mobility independent of the economic returns to self-employment (e.g., in providing opportunities for human capital development for themselves or their children; for providing opportunities for subsequent employment; and other outcomes of changes in network structure).

The review thus far has focused on economic mobility and the economic returns to self-employment. What about the non-economic mobility benefits of self-employment? The nonpecuniary benefits to self-employment are potentially great and include “being your own boss,” flexible working hours, and other “lifestyle” tradeoffs. Hamilton (2000) concludes from his findings of lower returns to self-employment than wage employment (estimating returns to self-employment at 25 percent or less than standard employment) that entrepreneurs are willing to sacrifice substantial earnings in exchange for the nonpecuniary benefits of owning a business. Indeed, some studies find self-employed have higher levels of job satisfaction than wage and salary workers have (Kawaguchi 2004, Fairlie 2005b).

### **Subpopulation Effects in the Role of Self-Employment in Economic Mobility**

Self-employment can have different mobility effects for different populations. For example, does self-employment provide greater gains for immigrants? Does self-employment provide greater mobility for groups that face discrimination or other mobility limits in standard employment? It is often said that the “glass ceiling” that groups such as minorities or women face in the corporation leads to career changes into self-employment. While these accounts describe blocked mobility in standard employment, few assess the mobility subsequently achieved in self-employment. Although returns from self-employment are examined for different demographic groups, as summarized above, these studies do not differentiate between different types of entrepreneurship, and whether self-employment is sought for mobility or a tradeoff between satisfaction of self-employment and income from staying in standard employment. A longitudinal study of corporate “leavers” could provide data on the comparative economic mobility outcomes of self-employment and standard employment in the context of blocked mobility in standard employment.

There is some evidence to suggest that several groups do not fare well in self-employment. Fairlie and Robb (2003) use the Characteristics of Business Owners Survey to explain why black-owned businesses lag substantially behind white-owned businesses in sales, profits, employment size, and survival probabilities. They find that a lack of prior work experience in a family business among black business owners negatively affects black business outcomes. This may limit blacks’ acquisition of general and specific business human capital.

While self-employed black and Hispanic men earn less than their white counterparts, they may do better than black and Hispanic men in wage/salary employment. Fairlie (2004b) uses the NLSY and finds that self-employed black and Hispanic men have slower initial earnings gains but greater earnings increases over time than their minority wage/salary counterparts. Fairlie finds no statistically significant difference between self-employment and wage/salary earnings for neither black nor Hispanic women.

Self-employment among immigrant groups has long been regarded as providing greater mobility opportunities than standard employment. Fairlie (2004b, p. 153), for example, notes that “self-employment provides a route out of poverty and an alternative to unemployment or discrimination in the labor market. Glazer and Moynihan (1970, p. 36) argue that ‘business is in America the most effective form of social mobility for those who meet prejudice.’ Proponents also note that many disadvantaged groups facing discrimination or blocked opportunities in the wage/salary sector have used business ownership as a source of economic advancement.”

Evidence suggests a change in the immigrant self-employment rate. Camarota (2000) at the Center for Immigration Studies finds that in 1960 immigrants had a 44 percent higher self-employment rate than natives but by 1997 the immigrant rate was slightly *below* that of natives. This is likely due to recent waves of less-educated immigrants who are less likely to start a business and a composition toward more recent immigrants who are less likely than longer-term immigrants to be self-employed. The evidence suggests that self-employment historically provided opportunity to immigrants, though evidence of whether they achieved greater returns than they would have in standard employment is equivocal.

### **Types of Self-Employment and Mobility Outcomes**

At a conceptual level, what are the expected mobility outcomes of self-employment? Some self-employed do not consider mobility as a reason for self-employment and thus do not anticipate or even desire it as an outcome. Different types of self-employment can be categorized as “high-growth” businesses, as “lifestyle” businesses, or as income supplementing or income maintenance businesses. A number of researchers have attempted to develop a typology of self-employment and entrepreneurship (e.g., Gartner 1985; Gartner, et al. 1989). Although there are a number of different typologies, all make the crucial distinction between businesses that are intended to be high-growth and those that are pursued with explicit economic and non-pecuniary tradeoffs. It would seem important to try to understand the distribution of economic returns to self-employment to account for those self-employed that have made explicit choices for limited economic mobility.



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